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From Independence to Regulation: A Look into Major Accounting Scandals and the Changes Implemented by the Sarbanes-Oxley Act

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A Look into Major Accounting Scandals and the Changes Implemented by the Sarbanes-Oxley Act

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Abstract:

In my lifetime, the accounting industry has experienced many downfalls. Due to the myriad of scandals that rocked America's marketplace in the 2000's, accountants and investors alike saw the need for reworking within the industry. With this desire for change came the passing of the Sarbanes-Oxley Act into law on July 30, 2002.

The purpose of the project is to explore the accounting scandals that took place prior to enacting Sarbanes-Oxley. Although it is important to acknowledge that there were other accounting scandals that took place, such as Tyco, HealthSouth, Freddie Mac, this paper focuses specifically on the Enron and WorldCom scandals and how these two scandals played a large role in the need for and creation of Sarbanes-Oxley. By studying the environment of these businesses that led to their fraud, one can see a direct correlation between the issues at Enron and WorldCom and how SOX was designed to prevent those issues at other publicly traded companies.

This project also contains interviews with people connected to and affected by the passing of SOX. The first person I interviewed is Dr. Joseph Carcello. Dr. Carcello is the Accounting and Information Management Department Head at The University of Tennessee, Knoxville. He also has served on the Public Company Accounting Oversight Board (PCAOB)'s Standing Advisory Group, and he currently is a charter member of the PCAOB's Investor Advisory Group. The second person that I interviewed for this project is Barry Elkins who worked 12 years in the public accounting industry and later became the CFO and Senior Vice President of Direct General Corporation. He held his position at Direct General when the company went public in 2003, thus has firsthand experience with the changes that were implemented with the passing of Sarbanes-Oxley.

Introduction:

Prior to the accounting scandals of the 2000's, the accounting industry was mostly a self-regulated industry. Although the SEC had entrusted its authority to set accounting standards to FASB, auditors were a self-regulated group governed solely by the American Institute of Certified Public Accountants' (AICPA) auditing standards. However, the scandals that took place, such as Enron and WorldCom, revealed deeply hidden issues within American businesses and the accounting profession in general. According to Paul Krugman of *The New York Times*, "the Enron debacle is not just the story of a company that failed; it is the story of a system that failed. And the system didn't fail through carelessness or laziness; it was corrupted." Although the stories of accounting fraud and corruption are mostly the exception, not the rule, the need for changes within the accounting industry became indisputable when the world began to see the destruction that the scandals caused with regard to the average American. People all across the country were suffering at the hands of overpaid, overzealous executives of some of the largest companies in America.

The Enron scandal alone cost thousands of employees and investors their retirement account, shareholders lost $74 billion, and the employees were all let go. With the WorldCom scandal, 300,000 jobs were lost and investors saw losses of $180 million ("The 10 Worst Corporate Accounting Scandals of All Time"). With similar numbers seen in every major accounting scandal, the need for changes within the industry could not be ignored any longer. On July 30, 2002, congress passed the Sarbanes-Oxley Act with the hopes of regaining the confidence of investors worldwide and decreasing the possibility of the American markets being devastated by scandals again.

Business Industry Before Scandals and SOX:

Prior to the accounting scandals, the American marketplace was booming. The American people felt as though they could not lose by investing in the stock market. It appeared as though America, the people and the country, could not fail. Within the public accounting industry there was almost zero regulation from outside of the profession entrusting auditors with a great deal of power and responsibility (Garner 17). Accounting firms audited/regulated each other, which led to an "I'll scratch your back, if you scratch mine" relationship (Carcello). The absence of outside regulation also led to the firms emphasizing their consulting practices over any other department (Garner 17). With this lack of regulation, also came a deep intertwining between the firms and the corporations they audited. The close relationships between auditors and clients were partially attributed to years of continuous auditing (sometimes close to 20 years). This fact is, without a doubt, a major factor in the downfall of Arthur Andersen, one of what was then the "Big 5" accounting firms. The "Big 5" consisted of: Arthur Andersen, Deloitte & Touche, Ernst & Young, KPMG Peat Marwick, and PricewaterhouseCoopers. Within this group, each firm was regarded as extremely trustworthy, as well as knowledgeable within the accounting industry. In fact, according to Public Broadcasting Services (PBS), Arthur Andersen was "once known as the gold standard of integrity in auditing" ("Bigger Than Enron"). All of that changed, however, with the fall of Enron.

Enron and Arthur Andersen:

Enron Corporation was a company based out of Houston, Texas that was established in 1985 and focused its business on a number of different commodities related to energy (Messier 712). By the 1990's, Enron had become one of largest companies in America making it an extremely attractive company in the stock market. In 2001, Enron was ranked #5 on the Fortune 500 listing; then in a drastic turn, during that same year, Enron filed for bankruptcy citing a third quarter loss of $618 million and a $1.2 billion reduction in owner's equity. This abrupt change in Enron's profitability prompted the SEC's official investigation of the company. The investigation led to Enron announcing that the company had overstated its profits by $586 million over the last 5 years, essentially wiping out all its profits. Through their investigation, the SEC discovered an alarming amount of accounting errors in Enron's books, which led the SEC, as well as the public, to question the reliability of Enron's executives and their auditor, Arthur Andersen.

Enron hid their internal problems extremely well until the company began its downward spiral. One of Enron's biggest issues was weak internal controls throughout the company, which enabled its executives to perpetrate fraud. Furthermore, the company's management did not contain men of high integrity or character. Since the fraud at Enron has been exposed, former employees have said that Kenneth Lay, the company's CEO, did not like to pay attention to the details of management. These details that he believed to be unimportant were, in fact, material and greatly impacted Enron's survival in the marketplace (Bierman 41). Enron also favored aggressive accounting practices. The aggressiveness of these practices were so intense that it prompted an anonymous letter to Lay stating that because of Enron's questionable accounting methods, the writer feared that Enron would "implode in a wave of accounting scandals" (Bierman 42). After the fraud at Enron became publically know, Sherron Watkins, a vice president for Corporate Development at Enron, admitted to being the letter's author. While so many issues were transpiring and being questioned internally, the outside world only saw Enron's false financial statements, thus viewed Enron as a thriving company.

Since 1986, Arthur Andersen had been auditing Enron. Because of the long-standing relationship between the companies, Robert Bryce claims that by the end of the 1990's, Arthur Andersen was extremely reliant on Enron as a client, so much so that the firm could not have survived without Enron as a client (237). This revelation alone potentially explains why so much "escaped" the auditors at Arthur Andersen. During my interview of Dr. Joseph Carcello, he explained that Arthur Andersen had just experienced a separation with Andersen Consulting, which made the firm extremely vulnerable. With the loss of its consulting practice, an extremely profitable part of the firm, Arthur Andersen created its own consulting function within the firm. The creation of this consulting function led to a greater emphasis on that and less of an emphasis on auditing and its professional standards. According to Barbara Ley Toffler, after the split of Andersen Consulting and Arthur Andersen, the "mantra of the day" became "perform or get purged" (69). Toffler suggests that it was this type of firm culture that led to Andersen employees allowing Enron to commit fraud. Due to the split of the firms, Toffler claims that an excessive amount of energy and time was spent on the firm's feelings of frustration and rage against their former sister company that could have and should have otherwise been focused on seeing the misconduct of clients (70).

Although Arthur Andersen is not the only one to blame for Enron's ability to commit fraud, the accounting firm did play a large role. A major downfall of the firm was that it did not keep Enron's board aware of their concerns regarding Enron's financials. The auditors were aware that Enron possessed a large amount of risk that the public was not knowledgeable of, but made no attempt to rectify that (Bierman 136). Although a good number of the misstatements on Enron's financials were due to genuinely inadvertent errors, many of the errors were a ramification of large-scale fraud and collapse of auditing standards and policies (Garner 7). The biggest failing and the one that sealed Arthur Andersen's failure as an accounting firm was their shredding of documents after the fraud at Enron was exposed. Knowing that the firm would be investigated, David Duncan, a partner on the Enron account, advised several Andersen employees to begin the shredding of documents relating to the fraud at Enron (Toffler 214-216). Once the firm admitted to their shredding of documents, Arthur Andersen became the focal point of America's hatred, which ultimately led to the firm having to shut its doors on August 31, 2002 ("Arthur Andersen Goes Out of Business").

WorldCom and Arthur Andersen:

Shortly after the fall of Enron, WorldCom, a large telecommunications company based out of Mississippi had its fraud exposed, resulting in the largest bankruptcy in United States' history. The fraud at WorldCom was a product of CEO Bernie Ebbers's business strategy of acquisitions, which led to the company having $41 billion in debt (Romero and Atlas). One of the primary differences between the fraud at Enron and the fraud at WorldCom was the difficulty of execution. The WorldCom fraud was exceedingly simple.

Starting in 1998 until 2000, WorldCom continuously decreased its "reserve accounts held to cover liabilities of acquired companies" (AICPA). By doing so over those two years, the company managed to increase its revenues by $2.8 billion; however, this alone became insufficient to save the company and keep its investors happy, thus in December of 2000, an email was sent to a WorldCom office in Texas from the CFO instructing them to misclassify the company's operating expenses as long-term investments. The CFO's instruction to misclassify these expenses was a command worth $3.85 billion, which drastically increased WorldCom's net income and their earnings per share (AICPA). Despite these large adjustments to WorldCom's financials, it was not until 2002 that WorldCom's internal auditors began to look into the accounting practices that had taken place over the past four years. With more and more questionable accounting being discovered in WorldCom's wireless division, Cynthia Cooper, WorldCom's Vice President of Internal Audit, began searching for documents to support the company's accounting decisions. After the internal audit team at WorldCom discovered more unusual entries, Cooper decided to contact WorldCom's external auditor, Arthur Andersen, where she was told by an Andersen partner that "any aggressive accounting entries in wireless [were] balanced out on a corporationwide basis" (Farrell). After this talk, Cooper was contacted by WorldCom's CFO, Scott Sullivan, telling her not to speak to the company's external auditor about these accounting entries again, leading Cooper to the realization that fraud was present within her company and she needed to expose it (Farrell).

Although the executives at WorldCom did a relatively good job at covering their fraudulent activity, according to CRN, because the fraud at WorldCom was so basic, there is no excuse as to why Arthur Andersen did not catch the fraud. This extensive auditing oversight is what led to Arthur Anderson's demise ("Arthur Andersen at Center of Scandal Again"). It was "the WorldCom debacle [that] demolished what was left of Arthur Andersen's reputation" (Jeter 207).

Implementation of SOX:

After the myriad of accounting frauds that took place in the early 2000's, investors throughout the world needed a reason to trust American companies and auditors again. With the failing of Enron and WorldCom alone, investors lost around 254 billion dollars and about 320,000 employees lost their jobs (Ferrell). With numbers as staggering as these, the need for reform within the business industry was unquestionable. According to Robert Mueller, "the collapse of Enron was devastating to tens of thousands of people and shook the public's confidence in corporate America." Not only did the frauds expose major financial statement errors that needed to be addressed, it also uncovered a major issue with regard to the morals of executives. Even after the Enron fraud was exposed, Kenneth Lay claimed that he did nothing criminal. Based on what Arthur Andersen allowed Enron and WorldCom to get away with, it was abundantly clear that "none of the checks and balances that were supposed to prevent insider abuse worked; the supposedly independent players were compromised" (Krugman).

All of the issues that were uncovered with regard to both business and accounting pointed to one obvious action- change needed to happen, and it needed to happen fast. With that in mind, Congress passed the Sarbanes-Oxley Act of 2002 into law, which is regarded as "the most sweeping set of new business regulations since the 1930's ("The 10 Worst Corporate Accounting Scandals of All Time").

Breakdown of the Sections of SOX:

Within the Sarbanes-Oxley Act, there are 11 titles, all of which address certain shortcomings of the accounting industry that were exposed during the fraud investigations. Title I establishes the Public Company Accounting Oversight Board (PCAOB). With the establishment of the PCAOB came the end of self-regulation in the accounting industry. Title I establishes the PCAOB as a non-governmental entity, but it is overseen by the SEC (Ayers 3). As was seen with regard to Arthur Andersen's involvement in both the Enron and WorldCom frauds, accounting firms had too much power and not enough outside regulation, which allowed them to push the limits of their autonomy. Currently, all public accounting firms are required to register with the PCAOB, and their audits are subject to random inspection. That said, the PCAOB is the primary oversight body for public accounting firms.

Auditor Independence is the subject Title II. A major reason why Enron was able to hide their fraud from the public was their close relationship with Arthur Andersen. The client and firm were so intertwined that Arthur Andersen auditors and consultants had permanent offices at Enron's headquarters. The auditors also participated in Enron's employee ski trips to Colorado (Herrick and Barrionuevo). The goal of an auditor is to give the public an unbiased opinion on a company's financial statements; however, when auditors and clients have this close of a relationship, it is hard to believe that anything the auditor reports is unbiased. Title II attempts to restore the trust in an auditor's opinion by restoring the necessary independence. This section limits the types of services that an external auditor can perform for its clients. It also limits the amount of time that auditors can work on a specific company. David Duncan, the partner in charge of Enron's audit, worked on this audit for five years, had an office in Enron's building, and he and Enron's chief accounting officer were extremely friendly outside the office (Raghavan).

Title III addresses corporate responsibility. With this title, all public companies are required to create an independent audit committee that is charged with hiring the external auditor, paying the auditors, overseeing the auditors, and dealing with any issues that may arise. Keeping the audit committee independent of management allows the auditor to have a group to report to if any unethical behavior arises. For example, according to a former Enron executive, in a meeting once with an auditor from Arthur Andersen, Enron needed an opinion letter from the firm supporting their claim for $270 million in tax credits. Although the auditor at first refused, the Enron employees made it apparent that they would not let the auditor leave until they received the opinion letter they wanted (Garner 12). In situations such as these, the auditor now has an independent party that ideally will support them with decisions such as the one above. This title also forces the CEO and CFO to take a greater responsibility with regard to the company's financial statements. These two executives must certify for both quarterly and annual reports that they have examined the reports and believe that the financials are a fair representation of the company's financial position. Another major provision of this title is that if the CEO and CFO certify the financial statements, but later the financials must be reissued because of noncompliance with GAAP, they must return any bonuses that they obtained a year after the restatement of the financials. This should alleviate any incentives that executives may have to falsely adjust their company's financials.

The fourth title concentrates on enhanced financial disclosures. After the fall of Enron and WorldCom, a similar weakness in internal controls was discovered at both companies. This weakness undoubtedly played a role in the company's ability to hide fraud for the amount of time that they did (Bainbridge 155). To resolve that issue, Congress decided with the passing of SOX that both managers and auditors must assess a public company's internal controls. The company must also disclose any material adjustments determined by the auditor. This will allow for additional transparency between the company and its investors.

Title V discusses analysts' conflicts of interest. The need for analysts to be truly independent and unbiased came about after Jack Grubman, a well-known Wall Street analyst, admitted that he rated WorldCom's stock too high for too long (Ferrell 3). Jack Grubman was known to be close with the WorldCom CEO, and so with this admission came the scrutiny of investors and the SEC wondering if Grubman was a little too close to the telecommunications company (4). This section also requires that analysts disclose to the public any potential conflicts of interest (Ayers 10).

Under Title VI, which discusses commission resources and authority, the SEC is to hire two hundred professionals whose job it will be to monitor the accounting profession. Additionally, this title increases the funding that the SEC was previously receiving. With the extra employees and money, the goal is to have better oversight of auditors, auditor practices, and the accounting profession in general (Sarbanes-Oxley Act of 2002).

Studies and reports is the focus of Title VII. Under this title, the General Accounting Office (GAO) and the SEC shall perform five studies. Those studies and their reports will be focused on the consolidation of public accounting firms, credit rating agencies, violators and violations within the profession, enforcement actions, and investment banks (Sarbanes-Oxley Act of 2002). The goal of these studies is to give both the GAO and the SEC a better understanding of factors that in the past may have led to fraudulent activity and factors that, in the future, may contribute to the presence of fraud.

Title VIII, which covers corporate and criminal fraud accountability, details the punishments and penalties for violating any laws. This section increases the maximum sentencing to twenty years for anyone that "alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry" in any documents or papers that may be used as evidence within an investigation. This section directly correlates with the shredding of Enron documents by Arthur Andersen employees (Toffler 214-216). On top of that, this title requires external auditors to maintain documents that are relevant to their audits for a minimum of 5 years, and if the auditor fails to do so, he may be imprisoned for a maximum of ten years (Sarbanes-Oxley Act of 2002). This title also focuses on the protection of whistleblowers. Whistleblowers played an incredibility vital role in the exposure of the fraud at both Enron and WorldCom. Without the help of Cynthia Cooper (WorldCom) and Sherron Watkins (Enron), the fraud at these companies may not have been discovered when it was, and because of their importance, this section enacts a maximum imprisonment of ten years to any person that intentionally retaliates against a whistleblower.

Title IX addresses white-collar crime penalty enhancements. This title dramatically increases the maximum imprisonment time for criminal activities, increasing it from five to twenty-five years. This section also introduces punishments for CEO's and CFO's that certify financials that do not meet the requirements laid out in Sarbanes-Oxley (Sarbanes-Oxley Act of 2002).

Title X covers corporate tax returns, requiring that a company's CEO sign the income tax return (Ayers 13).

The final section of SOX, Title XI: corporate fraud and accountability, details directions for a company to follow if it is under review for violations. This title gives a maximum of twenty years sentencing for anyone who impedes an official investigation (Sarbanes-Oxley Act of 2002). It also allows the SEC to prevent companies from making any abnormal payments to executives during the company's period of investigation.

Interviews about SOX Today:

Twelve years after the passing of SOX into law, there are many varying opinions on what SOX has done for the American business world. To gain an understanding of the varying opinions on this act, it is imperative to talk to accountants who have had a first-hand experience with the changes implemented by Sarbanes-Oxley.

As previously stated, Dr. Joseph Carcello has served on multiple PCAOB advisory groups, thus has an incredible understanding about what the PCAOB desires Sarbanes-Oxley to accomplish, and what it actually has accomplished. According to Dr. Carcello, during the period of the Enron, WorldCom, Tyco, and HealthSouth scandals, he said, "it felt like there was a fraud a week." Having so many frauds come out at once showed a "systematic failure within the audit profession" (Carcello). When asked what he believed to be the reason that these companies were able to perform fraudulent activities for quite some time, he said that he believed it was "the perfect storm." According to Dr. Carcello, because large-scale fraud is relatively rare, it is hard to find. "If a senior management team wants to commit fraud, it is pretty easy because the audit committee and external auditors trust management. If they didn't, they wouldn't be there" (Carcello). Not only that, but the issues at Enron and WorldCom transpired around the same time that their auditor Arthur Andersen's consulting practice was splitting from the firm. Losing their consulting practice made Arthur Andersen start to focus more on the building of a new consulting practice, than they did on auditing, which lead to some low quality auditing (Carcello). Dr. Carcello believes that Sarbanes-Oxley was implemented for three main purposes: to remove self-regulation from the public accounting industry, to impose greater responsibility on senior executives of companies, and to provide a greater responsibility and obligation on the audit committee. When asked if he believes that SOX has accomplished all that it set out to, he says, "I think things are clearly better. The PCAOB has made improvements in focusing the firms on auditing. The attention and resources that auditing gets has improved, but it probably hasn't been enough." He claims that companies would say that since the passage of SOX, the financial qualities have improved and internal controls are better since management, as well as the external auditor, has to issue a separate opinion on a company's system of internal controls.

Although he does admit that the discussion of the cost versus the benefits of the implementation of SOX is a completely different conversation. According to Dr. Carcello, although Sarbanes-Oxley has accomplished a lot in its first twelve years, “there are problems that are still happening that need to be resolved” (Carcello).

Barry Elkins has seen audits from the side of an auditor in a public accounting firm, as well as from an executive of a public corporation being audited. With these experiences have come a deep understanding of the way in which audits work and a greater awareness of the standards to which the accounting profession holds its members. Although Mr. Elkins agrees that there were issues within the accounting industry, he does not think that the passing of Sarbanes-Oxley was necessary. He believes that if the internal control standards that were already in place had been properly enforced, there would have been no reason to pass SOX. According to Mr. Elkins, “SOX didn’t add anything. Legitimate companies were already doing 95% of everything that SOX implemented.” In his opinion, the only change that came about with SOX was its increasing the cost of an audit by hundreds of thousands of dollars. At Direct General, the implementation of SOX increased their audit cost by at least $100,000 (Elkins). When asked about whether he believed having the executives of a company sign off on the company’s financials was beneficial, Mr. Elkins responded by saying, “adding a signature from the CEO and CFO to attest that everything was done was useless. It was just so they could sue us. If someone was going to cheat, they were going to cheat, regardless of if they signed their name.” In Mr. Elkins’s opinion, the greatest downfall of SOX has been “the layer of bureaucracy that it added.” According to him, part of the problem was the accounting industry itself. It wasn’t that the government needed to be more vocal about what was already being done (Elkins). He believes that the best action the government could have taken would have been to simply make small adjustments to the laws and regulations that were already in place. In Mr. Elkins's opinion, "SOX, itself, was unnecessary. The assessment of internal controls was already there. The accounting industry dropped the ball, and then they let the feds squeeze in" (Elkins).

Conclusion:

Sarbanes-Oxley has inarguably been one of the most important acts to be passed in the United States. SOX has affected the business industry as a whole, it has made adjustments to what auditors do, and it has also helped companies gain back the trust of its investors. Depending on who is talking, the opinions on SOX will undoubtedly vary making the conclusion of if Sarbanes-Oxley was the right choice hard to answer.

The implementation of SOX has been a learning process not only businesspeople, but also for the government. In the beginning, smaller companies were complaining about the increased, unsustainable cost of audits after the changes brought about from SOX. Due to these concerns, Congress passed the Small Business SOX Compliance Relief Act in 2009. This act required the SEC to modify some of the requirements enacted by SOX for exempt small businesses, especially with regard to "annual management assessments of, and reports on, internal financial controls" ("H.R. 3775- Small Business SOX Compliance Relief Act").

Although there will always be the debate about whether SOX enacted too much or not enough regulation, all-in-all there seems to be a general consensus that some form of a change needed to happen after the frauds of the early 2000's. Although some people may believe there were other, more logical choices than passing SOX, accountants and businesspeople seem to appreciate the increased protection from fraud that SOX has brought with it. According to Ernst & Young, "at [the] ten year anniversary of Sarbanes-Oxley, corporate governance is stronger,

[and] audit quality is improved" (Tanna). In addition to Ernst & Young's opinion, Kaya Gillan, a writer for *The New York Times*, states that the greatest effect of SOX has been that,

> Those who would seek to provide the market with misleading numbers are less likely to be able to do so because the public company internal controls are now much more effective; independent auditors comply with stronger standards and also have an independent regulator to oversee their efforts on behalf of investors and other stakeholders; audit committees must now be more competent and engaged in overseeing the audit and financial reporting; and the Securities and Exchange Commission must now spend more of its resources in reviewing the quality of information that companies provide to the market (Gillan).

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